THE HONG KONG BANKING CRISIS OF 1982/86:
A REPETITION OF
THE UNITED KINGDOM SECONDARY BANKING CRISIS OF 1973/75

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ABSTRACT

The present study attempted to gather information about the background leading to the banking crises in Hong Kong in the period 1982-86 and in the U.K. in 1973-75. It sought to examine the relationship between the symptoms and the consequences of the crises. Attempts were made to find out if there were alternatives open to the local Government other than indiscriminately saving every problem bank. Remedial actions taken by the banking supervisors in both places were analysed. The ultimate objective of the study was to find out what could be learned from the banking crises in the two world-class financial centres so that appropriate action can be taken to prevent the recurrence of similar problems.

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CHAPTER 1

INTRODUCTION

> "Government Rescues Another Bank, $300M Credit Will Keep Hong Nin's Door Open------ The Commissioner of Banking, Mr. Robert Fell, yesterday assumed control of the Hong Nin Bank, marking the seventh time in three years that the Hong Kong Government has intervened directly in the banking sector."

This headline of the South China Morning Post on September 9, 1986 adequately revealed how serious the banking situation in Hong Kong was during the period. The Hong Kong Government, well-known as the last bastion of laissez faire policy on earth, was forced to intervene seven times in the banking sector. It was estimated that total cost of the rescue amounted to a minimum of HK$3 billion or perhaps as high as HK$4 billion[1].

Apart from the cost of public money, the action taken by the Government has met with many queries, both from the mass media and in public gatherings. Even Legislative Councillors, whose support in the Council enabled quick action by the Government to take over some of the banks, were openly querying the wisdom of such actions. "Public commentary, both within the legislature and throughout the business community, has revealed grave reservations about the Government's sweeping powers to support banks in trouble, often because of corrupt or criminal activities by their managements or by commercial blunder."[2]

In many respects, the indiscriminate action of the Hong Kong Government to bail out all the local banks which were on the verge of liquidation was similar to the famous 'lifeboat' operation taken by the Bank of England in conjunction with British clearing banks to save a large number of secondary banks in the period 1973-75.

Obviously there were many differences between the two; for example the lifeboat operation was taken to save secondary banks whereas in Hong Kong, the Government was saving commercial banks whose status and services offered resemble those of the U.K. clearing banks. The UK secondary banks include many conglomerates with diversified interests but the local commercial banks were restricted by law from engaging in large scale non-bank businesses. The UK rescue was undertaken jointly by the Central Bank and the commercial banks, with the cost shared, but the local operation was mainly done by the Government using public money, though in a few cases private enterprises were involved on commercial terms. However history repeated itself, albeit in another part of the world. With hind-sight, we could therefore say that what caused the secondary banking crises in the UK also caused the Hong Kong banking crisis in the period 1982-86.

CHAPTER II

OBJECTIVES AND METHODOLOGY

The importance of the recent banking crisis on the future political and economic stability of Hong Kong should not be under-stated. Hong Kong cannot afford another crisis of confidence during the run-up to 1997. A crisis of confidence may involve the local currency, the banking system or the smooth functioning of the economy.

The main objective of this research paper is to identify the causes and symptoms of the crisis. Bearing in mind the famous Marxist saying that history repeats itself, it is hoped that some measure could be found to prevent the recurrence of the same in the future. The other objective of this paper is to try to answer the numerous questions raised as to whether there were alternatives other than to 'nationalise' several of the problem banks and to spend so much of the public money to save others.

As a British colony (though now officially called a 'territory'), Hong Kong owes much of its development to the British system. The making of the local Banking Ordinance, in particular, depended a lot on the British experience. An investigation into British banking history may help develop our wisdom in understanding the local problem. The famous UK secondary banking crisis and the solution to the problem were therefore studied intensively with a view of identifying similarities between the two. Symptoms of banking problems which occured in both cases may be very good indicators for future reference. An understanding of the logic behind the 'lifeboat' operation may shed light on the reason behind actions taken by the local authorities.

Information on which the paper was based was in the main obtained from an extensive literature review. Library research was conducted at both The Chinese University of Hong Kong and the University of Hong Kong. As a result of this effort, valuable materials were obtained from journals, magazines and books. On the UK secondary banking crisis, the book <u>The Secondary Banking Crisis, 1973-75</u> written by Margaret Reid when she was a research fellow at Nuffield College, Oxford, was particularly valuable. Because of her involvement in reporting the incident when it first broke out, she was able to provide the most thorough anatomy of the crisis. Opinions of very senior officials of organisations which participated in the lifeboat operation could also be found. When one tries to find information on British banking topics, one will never omit such authoritative publications like <u>Bank of England Quarterly Bulletin</u> and <u>The Banking World</u> (formerly known as the <u>Journal of the Institute of Bankers</u>). The former is probably the only source where one can get to know on a regular basis official opinions of the British banking supervisors and the latter is the source of opinions of professional bankers.

On the Hong Kong front, partly because of the recent nature of the incident and partly because of the possible lack of interest in the issue, there have not been many relevant publications. There has not yet been a single book published on the issue but valuable information can be obtained from journals and magazines like the <u>Asiabanking</u>, Hong Kong Business, Far Eastern Economic Review etc.. Newspaper, especially the South China Morning Post, were also important sources of information. Because of his personal interest in this area, the writer of this paper has collected newspaper clippings since 1981 and these also became an important source of secondary information.

CHAPTER III

DEVELOPMENT OF THE CRISES

A. The Hong Kong Scene

Though the first Government action to "nationalise" a bank happened in September, 1983, the banking crisis surfaced long before that date. In early September 1982, the Tse Lee Yuen chain of jewellery shops suddenly closed their doors without mentioning how they were going to honour the large number of outstanding gold certificates issued by them. This triggered off a run on the Hang Lung Bank, which was rumoured to have lent heavily to the jewellery chain. The run was later suppressed after the Standard Chartered Bank (then the Chartered Bank) came to help. Towards the end of the year, following the disclosure of financial difficulties of two property giants, Eda Investment and Carrian Investment Limited, several small-size deposit-taking companies (DTCs) found themselves in trouble, and their registrations were suspended by the Government. These included Dollar Credit and Financing Ltd., America and Panama Finance Co., Axona International Credit and Commerce Ltd., Tetra Finance (HK) Ltd., Hong Kong Deposit and Guaranty Co. Ltd., and Whitehall Finance Ltd..[3] Of these, the Dollar Credit case was the most important in relation to subsequent developments. It closed its doors in November 1982 and was found to be short of HK$650 million.

Colin Martin, the Banking Commissioner, said that it was partly because of Dollar Credit that relationships between Hang Lung and other banks turned sour so that Hang

Lung was ostracized. The complicated relationships between Hang Lung Bank, Dollar Credit and several other quoted public companies which were in trouble caused suspicion in the banking community and eventually hastened Hang Lung's demise via the cutting off of most inter-bank credit lines.[4] This led to the emergency legislation by the Government on September 27, 1983 to take over control of Hang Lung in view of its possible non-payment of HK$148 million in cheques.[5]

This was followed by a near crisis which involved the Sun Hung Kai Bank. The bank used 70% of its net assets to purchase its headquarters from a quoted company controlled by its chairman. Before the crisis surfaced, two foreign financial institutions announced the joint acquisition of the controlling shares of the bank. The Government acted this time behind the scene by announcing the addition of the bank to its list of qualified depositories for the official Exchange Fund.[6]

The next real crisis which occured six months later was a more dramatic crash. On June 6,1985 directors of the Overseas Trust Bank declared the bank to be insolvent and unable to continue operating. Sir John Bremridge, the Financial Secretary, ordered the closure of all branches of the bank until further notice.[7] The Legislative Council then passed an emergency bill to enable the Government to take control of the bank. By virtue of this, the Government was in effect also taking control of another bank, the Hong Kong Industrial and Commercial Bank, which was 60% owned by OTB. It was later found out that HICB was also in trouble as, after provision for bad and doubtful debts, the bank's net assets became a negative figure.[8]

Not too long after this, another rescue action was taken by the Hong Kong and Shanghai Banking Corporation and the Bank of China jointly by extending a "substantial" standby secured credit facility to the Ka Wah Bank on June 7, 1985.[9] In subsequent developments the bank was acquired by the China International Trust and Investment Corporation (CITIC) by a cash injection of HK$350 million in exchange for 92% of its ownership. The Government was reported to be acting behind the scene by undertaking to indemnify CITIC against bad debts outstanding in three years' time.[10] Later in the year in December, Hang Seng Bank provided HK$176 million in return for 50.3% control of Wing On Bank. Auditors Peat Marwick, Mitchell discovered that almost HK$275 million of bad and doubtful debts could be tied to a previous director. Again the Government pledged a guarantee of its interbank debts.[11]

The fifth rescue action by the Government involved the small Union Bank. On March 27, 1986, the Banking Commissioner directed merchant bankers Jardine Fleming to take over the management of the ailing Union Bank on his behalf. Union Bank was running into problems on a significant portion of its loan book when its chairman left for medical treatment in the USA and stayed there since September 1985.[12] The Government again supported the bank with an undisclosed credit line. The Government's control was phased out later when the bank was acquired by a Sino-US joint venture firm including the China-backed China Merchants Steam Navigation Company at the end of June 1986.

Despite the Government's repeated assurance that there would be no more bank failures, the Commissioner of Banking assumed control on September 8, 1986 of the Hong Nin Bank, marking the seventh time in three years that the Government has intervened in the banking sector. The announcement came as a surprise as First Pacific Holdings, a finance group in Hong Kong, had already announced its intention to buy Hong Nin. It was believed that the difficulties of Hong Nin surfaced during the course of First Pacific's examination of the bank.[13]

At the time of writing this paper, it appeared that the rescue action had come to an end. From the start of the DTC crisis in 1982 until the Hong Nin rescue in 1986, the most serious banking crisis in the history of Hong Kong lasted for five calendar years.

B. The U.K. Scene

The U.K. secondary banking crisis came quite suddenly. In November 1973, the London and County Securities (L & C) found itself in liquidity difficulties, being unable to renew deposits taken through the money markets. The Bank of England decided to save L & C, and thereby to protect its depositors. When the affairs of L & C were investigated, it was found that 80% of its deposits were repayable within three months, whilst its assets were highly illiquid property investments and loans to associated companies which had used to money to purchase property from L & C.

The collapse of L & C led to a widespread financial crisis affecting all those financial institutions which had financed property development from short-term borrowing. The large wholesale lenders descended on the entire secondary banking sector and called back everything they could. On December 20, 1973 the Bank of England recognized that a general crisis was developing. At a late night meeting between senior Bank of England officials and directors of Cedar Holdings, the second secondary bank soon to reveal its problems, the Bank felt that the crisis would be transmitted, through a domino effect, to the many other secondary banks which were also using short-term borrowing to finance their assets tied up in the increasingly troubled property sector. Thus, on December 21, 1973, the Bank of England announced that it was forming a committee with the clearing banks to provide support to any bank which the committee considered worthy of rescue.

As it turn out, at least 25 secondary banks received help, of which eight went into liquidation, one was scaled down and sold off, and 14 of the remaining 16 were later taken over.[14] At its peak in March 1975, the amount of support put up by the committee reached £1,285.4 million.[15] Of the money at risk in the operation, the Bank of England took a stake of 10 per cent. The clearing banks' 90 per cent share was divided up in the ratio of their eligible liabilities.[16] The banks, as clearers for the banks in trouble, also took over some of them in the process of rescue. Margaret Reid said that the incident "marked a new departure in introducing the principle of joint action by the central bank and leading commercial banks to deal with, not only one, but a number of threatened banking disasters."[17]

CHAPTER IV

CAUSES OF THE CRISES

1. Vulnerability of the Fractional Reserve Banking System

Mr. David Nandick, Hong Kong's Secretary for Monetary Affairs, has said that "there could never be a system where banks would never get into difficulty."[18] This is very true since the banking system is based on depositors' confidence. Despite this fact, there had seldom been serious problems with the banking system of developed countries for more than three decades since the Great Depression. This was because in those days banks were practicing asset management in their operation. Today the risk of bank failures is becoming higher as most banks indulge in "liability management". This is a practice whereby banks keep on capturing lending opportunities and then buy in assets to balance their books. The major source of funds is the secondary money market, mainly the inter-bank market, which is very short-term in nature. This therefore aggravates the mismatching problem. It is therefore said that while banks are lending for longer terms (e.g. property development), they are borrowing shorter than before when they have to borrow from the interbank market. Due to whatever reason, once this source of funds is stopped. the borrowing bank will be in grave trouble. As mentioned in page 9, the immediate cause leading to the trouble of L & C which triggered off the secondary banking crisis in the U.K. was also due to the stoppage of interbank credit lines. A general feature of virtually all the secondary banks during the crisis was that short-term funds from the interbank market were relied on to finance venturesome share investments and loans, even to the extent that the interbank funding became a far more important source of finance than personal deposits. This therefore made the risks more acute when the cash was committed to assets of vulnerable value. The fractional reserve banking system is becoming more vulnerable today when banks are tempted to mismatch their books.

2. Increased Money Supply and the Property Boom

The Government's monetary policy also gave rise to the banking crises under study. In Hong Kong, the period 1977-82 was one of "overheating" with excessive growth in monetary aggregates and credit. Table 1 compares the growth of money stock in Hong Kong, Taiwan and the USA during the period. It can be seen that while Hong Kong's real growth rate during the period was only slightly higher than that of Taiwan and the USA, its growth rate of M2 and M3 were significantly higher than the other countries. A very unhealthy situation of Hong Kong has been that its economic growth could always cause more than proportionate growth of credit to the property sector. From end-1978 to end-1982, these loans by licensed banks grew more than four-fold from HK$10.2 billion to HK$47.6 billion, while their proportion in the total loan portfolio rose from 22 per cent to 34 per cent.[19]

The property boom in the same period also prompted some banks to abandon common sense in their lending policies. Many banks over-committed themselves to a business which was justified. As is well known, real estate loans are among the most lucrative earning assets of a bank, but they are also

Table 1

Growth Rates of Money Stock

(per cent per annum)

Year	Hong Kong M1	Hong Kong M2	Hong Kong M3	U.S.A. M1	U.S.A. M2	U.S.A. M3	Taiwan M1A	Taiwan M1B	Taiwan M2
1977	28.6	20.7	N.A.	8.1	10.9	12.4	30.0	34.4	32.0
1978	23.2	25.6	N.A.	8.2	8.3	11.2	32.4	35.3	31.0
1979	3.7	13.2	29.7	7.4	8.8	9.4	8.9	10.2	9.5
1980	15.7	28.7	39.9	6.5	8.9	10.1	16.4	19.1	21.9
1981	4.1	21.3	27.4	6.4	10.1	11.9	9.6	16.5	18.6
1982	9.1	77.0	42.3	8.5	9.2	9.7	7.7	16.5	23.8
1983	12.4	24.7	23.7	9.3	11.7	10.0	13.1	17.3	26.0
Average	13.8	30.2	32.6	7.8	9.7	10.8	16.9	21.3	23.3

Source: For Hong Kong, Hong Kong Monthly Digest of Statistics. For U.S.A., Federal Reserve Bulletin. For Taiwan, Financial Statistics Monthly, The Central Bank of China.

Definitions

Hong Kong Money Supply

M1 = Total legal tender notes and coins with the public, plus customers' demand deposits with licensed banks.

M2 = Total M1 plus customers' savings and time deposits with licensed banks, plus negotiable certificates of deposit issued by licensed banks and held outside the monetary sector.

M3 = Total M2 plus customers' deposits with licensed and registered deposit-taking companies, plus negotiable certificates of deposit issued by deposit-taking companies held outside the monetary sector.

U.S. Money Supply

M1 = The sum of (1) currency with the public; (2) travelers checks of nonbank issuers; (3) demand deposits at all commercial banks other than those due to domestic banks, the U.S. Government, and foreign banks and official institutions less cash items in the process of collection and Federal Reserve float; and (4) other checkable accounts at banks and thrift institutions.

M2 = M1 plus money market deposit accounts, savings and small-denomination time deposits at all depository institutions, overnight repurchase agreements at commercial banks, overnight Eurodollars held by U.S. residents other than banks at Caribbean branches of member banks and balances of money market mutual funds.

M3 = M2 plus large-denomination time deposits at all depository institutions, term RPs at commercial banks and savings and loan associations, and balances of institution-only money market mutual funds.

Taiwan Money Supply

M1A= The sum of net currency, checking accounts, and other sight deposits.

M1B= The sum of M1A and savings deposits.

M2 = The sum of M1B and quasi-money (time depositis, fixed-term savings deposits, postal savings deposits etc.).

Quoted from "Recent Banking Crises in Hong Kong and Taiwan: A Comparative Perspective", Y.C.Jao the most illiquid and risky. Small banks with limited capital may reach a state of over-reliance on this sector without being aware of it. David Nandick said: "We have analysed the sort of problems that have led to the difficulties over the past few years. Those difficulties are similar to what had happened elsewhere, namely the concentration of lending to one or more connected borrowers."[20] It has been felt by some in the past that the typical local bank was too small to have been a keen major lender to property developers or a partner in large property syndications. The real situation, as can be seen now, was that the banks' customers might be heavily involved in property, even when, on paper, they were merely manufacturers or merchants. This was exactly what contributed to a large part of the bad debt incurred by the Wing On Bank.[21]

Nevertheless, property has come to dominate the local financial sector in the past, and the situation is not likely to change. From official statistics, about a third of all bank and DTC lending in Hong Kong goes to property development, building and construction, or to property purchases. It was reported that in the thirty months ending June 1982, just under HK$24 billion was raised through syndicated loans domestically, of which 80 per cent was for property.[22] It was therefore inevitable that the collapse of the local property market in 1983 had a strong bearing on the profitability of every financial institution operating here, either for local branch banking or as a regional headquarters.

Table 2

Growth Rates of Domestic Credit
(per cent per annum)

	Hong Kong			Taiwan		
Year	Licensed Banks	DTCs	Total	Domestic Banks	OFIs	Total
1977	25.4	N.A.	25.0	18.3	31.7	22.0
1978	43.3	N.A.	43.3	25.0	34.5	27.9
1979	34.1	36.1	34.5	15.8	17.6	16.4
1980	52.5	116.1	63.9	27.3	26.6	27.1
1981	31.7	56.6	37.6	9.6	18.5	12.4
1982	31.1	26.1	29.7	18.8	14.7	17.5
1983	18.0	-6.3	11.7	14.3	19.5	16.0
Average	33.7	45.7	35.1	18.4	23.3	19.2

Note: N.A. = not available; OFIs in Taiwan mean "other financial institutions", including medium business banks, credit cooperatives, credit departments of farmers' and fishermen's associations, investment and trust companies, postal savings system, and life insurance companies.

Source: Hong Kong Monthly Digest of Statistics and Taiwan Statistical Data Book.

Quoted from "Recent Banking Crises in Hong Kong and Taiwan: A Comparative Perspective", Y.C.Jao

This kind of effect has long been noticed. The consequence of the 1983 property slump had however not been perfectly perceived. Mr.Frederic Dubois, General Manager of Paribas Asia was quoted to have said: "Banks have to be adult. These banks are here to share in extra-ordinary profits generated by the Hong Kong economy when things go well, so they shouldn't be scared when there's a downturn."[23] Mr. Peter Dodd of Barclays Asia also said that "you can't enjoy the fruit of laissez-faire and then complain that the Government doesn't intervene when things go wrong."[24] The bankers thought that the property slump was just part of the regular economic adjustment and did not envisage that the Government had to intervene, not only once, but many times later.

In the U.K.,the crash was also linked with the money and property boom. The Government chose to continue its pursuit of high economic growth and low interest rate policy. Also owing to the rapid growth of the wholesale money markets, the money supply as measured by M3 was growing twice as fast as M1.[25] Table 3 demonstrates that from October 1971 to mid-1973 borrowing on the developing sterling interbank wholesale markets virtually trebled (from £3,867 million to £11,222 million).

The dramatic growth of the money stock was not used to finance industrial growth. As in other depressed economies, the demand for money from the manufacturing industry remained low throughout 1972 and early 1973. Property development thus absorbed a major share of the rising money supply. In the period 1971-73, bank lending to the property sector roughly quadrupled. Moreover, this growth

TABLE 3 Sterling Borrowing Inter-bank and on Certificate of Deposit

	All Banks			London clearing banks		
	Inter-bank	*Issues of CDs*	*Total*	*Inter-bank*	*Issues of CDs*	*Total*
1971						
Oct	2004	1863	3867	183	83	266
Dec	2200	2242	4442	309	203	512
1972						
Mar	2814	2768	5582	337	406	743
June	3295	3595	6890	498	564	1062
Sept	3895	4487	8382	543	1083	1626
Dec	4573	4926	9499	592	1292	1884
1973						
Mar	5035	5307	10342	858	1722	2580
June	6134	5088	11222	967	1745	2712

Source: *Midland Bank Review*, Aug 1973.

occurred despite a Bank of England caution, issued as early as August 1972, against overlending to the property sector.[26] Banks at this time took risks in lending a very high proportion --75 or 80 per cent-- of the value of the land or buildings charged to them as security; if the lender was taking an equity stake in the project, as secondary banks often did, up to 90 or 100 per cent of the value was often advanced. A writer even reported that some banks even lent in excess of 100 per cent to allow for professional fees and advice.[27]

Under this atmosphere, the growth of the money stock caused serious alarm amongst overseas holders of sterling and a run on the sterling pound developed. On July 27,1973 the Bank of England was forced to increase its Minimum Lending Rate (MLR) by four per cent from 7½ to 11½ per cent, thus drastically altering the economics of borrowing. As the secondary banks had traded on the simple basis that they could always roll over their loans from the wholesale market, long-term loans they had made earlier in the year then began to look like bad deals. In November 1973, with the outbreak of the oil crisis, a further increase of the MLR to 13 per cent and the Chancellor's announcement of his intention to introduce a development gain tax, the London Stock Market collapsed and the banking crisis became imminent.[28]

3. Mismanagement and Fraudulent Practices

In Hong Kong, there were incidences of owners and managers of small local banks using depositors' money to fund their own speculation, protected from discovery by the undemanding nature of local bank supervision.[29] The Banking Commissioner admitted that fraud by top management was most difficult to detect and eliminate and would continue to be so.[30] Appendix I shows several court cases which had surfaced. Perhaps there would be more to come.

There were other cases of mismanagement whereby family-run banks usually found it difficult to reject credit requests by close borrowers who had always regarded loans as almost theirs by right.[31] Appendix II shows that in some cases, sums higher than shareholders' funds were lent to insiders. This also leads us to suspect that there might have been other cases unrevealed by court action which involved lending to nominee companies which were by law able to hide the identity of the real owners.

In the U.K. there were also several court cases as an aftermath of the secondary banking crisis. The first one was linked with Sterling Industrial Securities. A shareholder and director of the company, Mr. Finley, was convicted of corruption concerning loans to a Mr. Wheatley, representative of the Crown Agents on the board of the company. Mr. Wheatley died in 1977 before charges brought against him were heard. Mr. Davidson, Managing Director, was also sued by the Crown Agents saying that a sum belonging to the Crown Agents was given to him as an unsecured loan due to the improper and unauthorised actions of Mr. Wheatley.[32]

The second court case involved another secondary bank with Israeli connection. Mr. Harry Landy, who ran the Israel-British Bank, was jailed in Britain after being found guilty of conspiracy to defraud and of conspiracy to utter forged documents. However, in January 1981, the Court of Appeal quashed his convictions.[33]

The third one concerned L & C, the company which triggered off the crisis. The inspectors report published in 1976 concluded that Mr. Caplan and one other executive director had operated fraudulently in a number of transactions; and that the bank balances shown in the accounts of L & C and its principle subsidiary for the financial year ending March 31,1973 had been deliberately inflated with the intention of deceiving depositors and others as to the businesses' liquidity. As a result, Mr. Caplan and nine others faced theft and other charges in court involving some £10 million.[34]

The fifth case was brought against Mr. John Stonehouse, who ran the London Capital Group, as a result of which he had to serve jail sentences.[35]

There were other legal follow-ups. Inspectors were reported to be investigating the affairs of Grendon Trust and the involvement of the Crown Agents in the business of the secondary banks. Proceedings were brought by the Trade Department against Mr. Jim Slater of Slater Walker Securities under Section 54 of the Companies Act, which prohibits companies from financing purchases of their own shares. Mr.Slater was afterwards convicted on fifteen charges and fined £15 on each.[36]

These are the three main reasons common to the banking crises in both places. There is, however, another cause which contributed to the local problem.

4. Weak Ownership

Banking Commissioner Robert Fell has said that a noticeable weakness which had been identified during the crisis was the weak ownership of some local banks. Some of them might have suffered losses but still had a reasonable net worth. Had fresh capital been injected before rumours spread too far, these banks would not be in crisis. Their owners were however reluctant or unable to restore the capital to a proper level.[37] These banks were also characterised by their manifold and complex links with overseas Chinese businesses and businessmen throughout Southeast Asia, especially with Malaysia and Singapore.

Appendix III shows the overseas connections of the banks in crisis. Examples since the collapse of property companies like Carrian and Eda and before the banking crisis under study may lead us to infer that the way some groups of Chinese businessmen conduct their businesses should lead a prudent law enforcer to pay special attention to their business practices.

CHAPTER V

JUSTIFICATIONS FOR THE RESCUE

When the rescue action was launched to "nationalise" Hang Lung Bank, the general feeling throughout the Hong Kong business community was favourable. But when the Government took action to save the rest of the ailing banks, public reaction was mixed. Civil servants, bankers and some Legco members said the actions were inevitable. Others, especially the academics, were doubtful of the justification for the last several rescues.

The reasons stated by Sir John Bremridge in a press conference on September 27, 1983 after the rescue of Hang Lung Bank could also be the reasons for subsequent rescues.[38] The first reason behind the Hang Lung Bank (Acquisition) Ordinance was to safequard the depositors' interest. It was reported that OTB alone had as many as 100,000 depositors and this group of people, who are mostly small savers, may cause a lot of public discontent under a political atmosphere which was already not very stable. In fact, the political tension in the run-up to 1997 makes the Government reluctant to allow even small ripples in the banking sector for fear that they may grow into a major crisis of confidence.

The second reason given was to protect employment of the staff. This one is subject to arguments. When this was done on a very small scale like that of rescuing Hang Lung Bank, there might not be much opposition. Obviously there was no reason for this to be carried out indiscriminately to all banks but not to other industries. Therefore this reason has not been cited by any Government official after the Hang Lung case.

The third reason was to maintain world confidence in Hong Kong as the world's third financial center. Sir John Bremridge stressed after the Hang Lung takeover that "the Government remains committed to its policy of safeguarding the exchange rate of Hong Kong dollar and the stability and reputation of the banking system."[39] This is perhaps the most important reason behind the series of Government actions. As Margaret Reid put it in defense of the lifeboat operation in the U.K.:

> "the gains are not precisely quantifiable since they consist largely in the avoidance of dangers to the whole banking system which, because the worst did not happen, can never be the subject of more than judgement and estimate.What is clear is that confidence in British (Hong Kong) banking was preserved and the rot was stopped from spreading ....Depositors were fully protected."(40)

The Deputy Governor of the Bank of England pointed out in 1983 that in certain circumstances, the collapse of a bank could, in the absence of any official action, lead to a loss of confidence in the system as a whole and a massive withdrawal of funds.[41] He said:

> "Individuals may be unable to judge quickly whether the failure of the individual bank is due solely to its own shortcomings or whether the factors that brought it down are more general. At the same time, these individuals may withdraw their deposits not just from one bank but from the whole banking industry and turn them into cash with great speed and at little cost. In this context, formal disclosure requirements are unlikely to be of much practical assistance. Irrespective of the strength of a bank's balance sheet on objective grounds, it may still be rendered insolvent by the actions of other depositors. As a result,banks which are perfectly solvent and hold sizeable liquid reserves can suffer a liquidity shortage which might cause them to fail."

With the limited information available, this could also be one of the reasons why the Government took control of the Union Bank, whose net asset value was said to be on the positive side.

Another gain from the whole strategy was that, again like that of the lifeboat, problems were solved in such a way that no borrowing bank defaulted on its obligation on the international scene. This would have had damaging repercussions on confidence in Hong Kong and indeed generally in international financial markets. However, how likely the international chain reaction would happen was difficult to ascertain because the Government has never revealed what portion of the banks' deposits were from international institutions. One may worry that, if such a sizeable bank like OTB was allowed to subside, foreign banks would withdraw from the local money market and Hong Kong's credit risk as a financial centre would inevitably be reassessed. In this respect, the philosophy of the Hong Kong Government might have been influenced by the lifeboat operation of the U.K.. The rescue of the OTB, which may cost the Exchange Fund HK$2 billion, may also be a reflection of the principle of "parental responsibility"[42] propounded by the Governor of the Bank of England. The principle put forward by Mr. Richardson was that parent banks should accept responsibility for the well-being of their offshoots the world over and that supervisory authorities should interest themselves in this being done. The OTB was the third largest local bank at the time of its collapse and it had eight branches overseas. These include one in Macau with deposits of HK$150 million and another in Canada with assets reported to total US$36.7 million.[43] There were also branches in London, Bahrain and San Francisco. Had the Government allowed OTB to collapse, it might have created crises at places like Columbo and Macau. With the adoption of the principle of parental responsibility like that of a central bank, the Hong Kong Government was in effect helping these small countries avoid possible crises.

It has been said that the Government might have developed the habit of rescuing ailing banks. However, the writer's opinion was that the Government's behaviour was a demonstration of moral responsibility. The Financial Secretary had repeatedly declared to the public the Government's determination to maintain the stability of the banking sector and, every time after a rescue, senior Government officials said no other banks were in trouble. Therefore the Government had acquired a moral responsibility towards those depositors who had not withdrawn their money from local banks because of their awareness of the official declarations.

It was because of all these important but unquantifiable factors that the rescue action performed by the Hong Kong Government won the praise of the Chinese Government. The State-owned New China News Agency supported the move and said it was correct to use the Exchange Fund to save the problem-ridden banks.[44]

However, there were still a lot of objections to the generous action of the Government. The following points have been raised:

First the cost of the rescue was tremendous. Estimates have varied from a low of HK$3 billion to a high of HK$4 billion.[45]

Secondly it was felt that the Government rescue was fundamentally alien to important principles which have made Hong Kong successful.[46] The opinion was that any social or economic consequences arising from the collapse of a not insignificant bank were part of the short-term price to be paid to maintain that success in the long-run. This point cannot stand if we accept the assumption that any bank failures in Hong Kong will affect its reputation as a financial centre. No one can prove whether this assumption is valid or not. The most we can say is that the Government is too conservative or is extremely prudent so that it dare not take the risk, no matter how small the chance is.

A third criticism of the Government's philosophy is based on equity grounds. A vice-chairman of the Chinese Manufacturers' Association said the Government repeatedly rejected the establishment of an industrial bank to assist the industrial sector but spent billions of tax-payers' money to save banks. He questioned the fairness of banks paying dividends to shareholders in good times and public money being used to bail them out in bad times. He therefore suggested that the Government should allow any bank to close its doors, as the Singaporean Government allowed Pan Electric Industries to collapse.[47]

The fourth criticism concerned the lack of information from the Government to support its actions. This was raised by an outspoken Legco member, Mr. Szeto Wah, who said:

"I am very concerned about whether there might be more banks running into financial trouble, and whether the Government would continue to come to their rescue..... I think the Government should clearly state under what conditions will it rescue an ailing bank."[48] Every time the Government was forced to save another bank, the financial secretary said that it was the last time and all other banks were in a good state of health. Even Legco members, who passed bills to enable the Government actions, were not happy with the meagre information they could obtain. Mr. Martin Lee, another Legco member, also queried the way the Government saved one bank after another. He did not want to see the Exchange Fund resorted to every time there was a troubled bank. Mr Lee further argued that regardless of the fundamental merits of banking rescues, they should be carried out only with public accountability of the money involved, not behind the veil of Exchange Fund secrecy. "Secrecy begets suspicion", said Mr. Lee on March 26, 1986, attacking the Ka Wah bail-out.[49]

With the meagre information the Government leaks out, there appeared grounds for another argument. Some of the banks rescued were not that critical. For example, it was said that the Union Bank had sufficient assets to allow it to seek help from commercial banks.[50] On the other hand the OTB case would not be a bad bankruptcy as it had the assets to pay off creditors at the rate of 70 cents on the dollar.[51]

A final point against the indiscriminate bank rescue was very embarassing to the Government. Mr. Richard Farrant, an advisor from the Bank of England to the local Commissioner of Banking, said that an efficient banking system required periodic invigoration by new entrants to it, and periodic cleansing by the removal of failures. Stressing that these were his personal views, Mr. Farrant further pointed out that the Government could not cope with many more rescues.[52] His theory sounds all right; at least it was in line with the spirit of capitalism. However the banking industry is not like the grocery business where the principle of survival of the fittest is accepted by everybody. The banking industry involves thousands of depositors whose savings in the bank are certainly not the same as money lent to a businessman for a high return and at a high risk. If Farrant's theory stands, the lifeboat was the largest mistake committed by England 's central bank in human history.

There will never be an answer to the question as to whether it was correct to rescue banks, whether in Hong Kong or in the U.K. However, a knowledge of all these favourable and unfavourable comments will help us formulate our own opinions.

CHAPTER VI

ARE THERE ALTERNATIVES?

If one feels that the Government should not take a laissez faire attitude, the next question to be asked is, "are there other alternatives?" The answer is again affirmative but not in the normative sense.

The first alternative is, while personal depositors with troubled banks should be safeguarded, companies and other institutions which had lent to these banks should have known better and ought to be left to bear the consequences. Social unrest will then be avoided as those who could not afford to lose were protected. However this may not be appropriate for the interest of Hong Kong as a reputable world financial centre. Though the major banks would remain as trustworthy as they have been, this move would in effect drive all local banks,especially those smaller ones, out of business. Not only will institutional lenders stop lending to these small banks, small depositors would also leave them so as not to risk a future Government's change of mind. Furthermore, it is doubted whether institutional lenders did have more information about the bank's borrowers. Under the existing legislation, the volume of information banks are required to disclose is far from being enough to formulate a sound opinion.

Secondly, it was suggested that it was not necessarily in the interest of confidence to rescue all affected banks. This approach envisaged that if some of the least respected names were allowed to collapse in a flurry of publicity with losses to their depositors, it would have acted like a quick piece of surgery on the banking system, cutting out the canker and enabling the rest to continue. Richard Farrant has already suggested the possibility of making a hard decision to cancel the authorisation of a bank at an early stage to achieve a more orderly run down of the business.[53] He suggested that the practical action required to accompany the cancellation of the bank license would amount to a receivership on behalf of ordinary creditors. The bank would be required to cease to make new loans or investments and to liquidate or sell existing ones for cash. However the fact was that the major collapses were all at the early stage of the crisis. The risk of allowing the first few banks to collapse would be far greater than a prudent government would shoulder.

The third method by which the scale of the rescue could be minimised is to raise the conditions for help once general confidence in the banking system had been strengthened. Dr. Ho Yan-ki of the Chinese University of Hong Kong warned that if the Government was seen to be assuming heavier responsibility to back up mismanaged banks, others which find themselves protected from failure may be encouraged to take higher risks for greater returns.[54] When applied in Hong Kong, the consequence of this course of action would be that some banks may not be able to survive without unconditional help from the Government. As the causes of almost all the crises were largely the same since the Hang Lung takeover, this alternative may also lead to the question of fairness. Those savers who suffered losses when some banks failed to receive help at the latter stage of the crisis may ask why public money was used to save some, but not all.

The last alternative to be applied in Hong Kong might have been the U.K. lifeboat model. The operation may be jointly performed by the Government with the participation of commercial banks. Obviously this could only involve local banks. Under such a situation when even the third largest local bank failed, one may ask how many of the remaining banks are qualified to oin in the plan. Apart from the Hong Kong Bank Group which had already participated through its subsidiary Hang Seng Bank in the Wing On rescue, the only likely candidate is the Bank of East Asia. Even in the Wing On Case, Hang Seng was joining under the Government guarantee of Wing On's bad debt. The UK formula of requiring the commercial banks to be responsible for a share of the cost of rescue is beyond imagination in Hong Kong. This course of action may turn out to be a shock to the local community instead of building up confidence.

Had there been a central bank in Hong Kong or a mechanism providing deposit insurance, the choice of the Government might have been different. Under the given environment, if something had to be done, it would have to be done by the Government. When the Government had to do it, it would have to take into consideration the political stability of Hong Kong, the benefits of the whole economy and the fairness to all parties concerned. It therefore seemed logical for the Government to choose the most trouble-free method of saving all banks indiscriminately. The decision might have been influenced by the success of the lifeboat operation in the U.K. but irrespective of this, this seemed to be the only choice available at the moment.

Once this policy is adopted, there will never be a day in the future when the Government is free from the possibility of having to bail out problem banks. The closer 1997 draws, the greater the political tension, the lower the chance the Government is willing to see a crisis of any kind. The Government's immediate job is to ensure there will be no more problem banks.

CHAPTER VII

THE NEW BANKING LEGISLATION

As a result of the public concern over the loopholes in the existing banking laws, Government officials all commented during the crisis that a new bill would be drafted to tighten up the control of banks. The draft law was gazetted on March 6, 1986 and was passed by the Legislative Council on June 4 of the same year. The principal features of the new law are:

1. The Banking Commissioner has the power to appoint a second bank auditor. Procedures were also fixed to allow either the bank examiner or outside auditors to call a tripatite meeting with the bank management represented.
2. An institution shall not, except with the Commissioner's approval, lend against the security of its own shares, shares of its parent companies, subsidiaries, or other companies in the same group.
3. Any one acquiring 10 per cent or more of the shares of a Hong Kong bank must obtain the Commissioner's approval before they can vote the shares.
4. All appointments of directors and company secretaries of local banks would be subject to the Commissioner's prior approval.
5. The Commissioner would have blanket power to order a bank not to engage in any business practices which will or may cause the soundness

of the lending institution to be dependent on a single party.

6. Calculation of the 25 per cent liquidity ratio was changed from an annual to a monthly basis. It was stipulated that at least 25 per cent of any liabilities maturing within one month must be covered by liquifiable assets maturing within the same period. Definition of liquifiable assets and liabilities were given.
7. The capital adequacy ratio of local banks was fixed at 5 per cent for banks. A grace period of two years was granted before this clause is to be enforced.

Furthermore, it was also approved that the manpower of the Banking Commissioner's office would increase by 40 to a staff of 200 to enable the Commission to carry out more thorough checks on banks.

In summary, the new Ordinance gave very wide powers to the Banking Commissioner. The legislation was more flexible than before as it relied more on the Banking Commissioner's discretion and qualitative judgement.

With regard to the prevention of over-exposing a bank to the creditworthiness of a single party; if a bank has extended loans to a nominee company, the Commissioner may require it to identify the beneficial owner of that company. This is to determine whether the bank is over-exposed to the owner's creditworthiness. Should the bank fail to do so, the Commissioner may require full provisions against these loans. It was hoped that this would prevent a bank from over-exposing itself to party (parties) connected with its directors or shareholders which disguise themselves through nominee companies.

CHAPTER VIII

IS THE PROBLEM SOLVED?

Whether the new banking legislation will be effective in preventing future crises remains to be seen. After reviewing the causes and the course of the development of the crisis, the writer felt that the legislation only aimed at strengthening the quantitative aspect of the control mechanism. Control on the qualitative side appeared to be window-dressing:

1. Impracticality of the legislation

It could be argued that there were already provisions in the revised Ordinance to control those who are to be the owners and directors of banks. In reality, it is hardly an effective measure to prevent "any Tom, Dick or Harry from controlling millions of dollars of other people's money."[55] With the ownership and management of some existing family banks unchanged, the Banking Commissioner would find it difficult to reject an application.

2. Quality of Inspection

Some bankers felt that "legislation is one thing and the capability of the authorities to diagnose a problem is another."[56] They said that the new legislation gives the Banking Commissioner extensive powers, but even in the past he has had enough powers to do so. They stressed that it is more important to continue upgrading the quality of the Banking Commission office rather than changing legislation. Another writer reported that the Banking Commission's staff tend to regard themselves as respectable professionals rather than as policemen in search of financial criminals.[57] As the recent crisis was mainly caused by fraudulent acts, it is doubtful if the same kind of behaviour could detect symtoms early enough in the future.

At the dawn of the crisis of one of the collapsed banks, several bankers revealed in a meeting their knowledge of how that dying bank had been conducting its business.[58] These bankers had always been able to sense the presence of a sick or insane competitor in their midst. Why could not the examiner? Anyhow, this revealed an important source of intelligence the Commissioner could not neglect. It was because of the participants' knowledge of the other people concerned that the London Stock Exchange and the famous Lloyd's underwriters were able to function well. Those concerned broadly knew each other and knew whom to trust and for how much. This kind of market intelligence has traditionally formed the basis of the Bank of England's supervision of the British banking system. With the vast increase in the number of people and institutions involved, it may now be required that this method be supplemented by more formal information requirements. The Deputy Governor of the Bank of England declared that they still regard knowledge of the people concerned as the most important supervisory tool.[59] In a geographically small city like Hong Kong, where the number of small local banks is small and decreasing, this kind of informal supervisory tool would be found most suitable. But it appears that the Government bureaucracy would have to be modified to make this feasible. The trouble hunter may have to be present at a lot of business and social gatherings of bankers and securities brokers and must be prepared to collect gossip of whatever nature.

3. Abandon the interest rate cartel

The interest rate agreement has been in existence since the legislation revision after the banking crisis of 1964/65. The formation of the statutory body "Hong Kong Association of Banks" made it a legal requirement for all banks in Hong Kong to offer interest rates no higher than the HKAB rates. This has come under fire for a long time, but especially after the currency crisis when the local currency was "linked" with the greenback. Farrant felt that this caused the less highly-regarded banks to be unable to offer higher interest rates in order to attract funds from the public.[60] These banks therefore had to borrow from other banks even at higher rates . As the inter-bank money market as a source of funds is said to be the least stable form of finance available to banks, Farrant therefore concluded that the interest rate cartel has probably hurt the smaller banks rather than protecting them. This argument was supported by most economists and bankers but was opposed by those who are controlling large portion of local deposits and by Government officials. The abolition of the interest rate cartel would therefore make the small local banks less dependent on the interbank market and would make the banking structure more stable.

4. Greater Disclosure and Abandonment of Inner Reserves

The other important change recommended by Farrant was the case for greater disclosure.[61] He said that the availability of full information to bank users would enable them to discriminate sensibly. A discriminating customer base would help to maintain a healthy banking system. John Clutterbuck of Price, Waterhouse questioned "whether it was appropriate for auditors to say a set of accounts gives a true and fair view when one bank might have inner reserves of millions of dollars and another nothing at all."[62]

Mr. William Purves, Chairman of the Hong Kong Bank, felt that there was a great deal of merit in the system of inner reserves for financial institutions because it enabled some smoothing out of the difficult years and very good years.[63] Mr. Alexander Au, director and deputy general manager of the Hang Seng Bank said that scrapping the system could easily destabilise the economic situation of the territory, and, therefore, it was the last thing Hong Kong needed in its run-up to 1997.[64] His opinion was that, for a bank which was making a loss, disclosing such unadjusted figures might deprive it of a chance of recovery when depositors reacted irrationally to such results. This argument might be correct. But the writer felt that its effect in enabling a mismanaged bank to keep on attracting deposits from small savers could not be ignored. Furthermore, what made wide fluctuations in the profit figures of a bank were mostly the riskly items which a prudent bank should hesitate to enter into. These items included over-exposure to an individual or an industry. If a bank decided to take such risks in order to make higher profits, it should not be protected from seeing the retreat of its depositors.

Farrant suggested that the present moment is a good opportunity to move towards greater disclosure. He said: "the public are growing used to the fact that banks have problems. They no longer expect an automatic increase in profits year after year. They no longer believe all banks have massive inner reserves hidden away."[65] Mr. David Nendick, Secretary for Monetary Affairs finally admitted that "they (inner reserves) should not be used for purposes other than to avoid the sort of random shocks in the performance of banks that arise merely from the fact that sometimes a risk turns into a bad loss, nor should they be used to conceal the overall progress of the bank."[66] As a result, the Banking Commissioner was conducting a study aiming at ensuring that the use of inner reserves did not mislead the general public and the shareholders. Confidence in the banking system would improve if depositors and creditors all knew that the financial statements revealed the true financial picture of the bank concerned.

5. <u>The Need for Deposit Insurance</u>

Another recommendation which the Government had no intention to concede was the need for a deposit insurance scheme. Academics from both universities felt that in the long-run such a scheme would benefit the banking industry.[67] This question was however complicated by the fact that there were both very big and very small local banks and that local deposits were concentrated in a few major banks, which would argue that, given their sound position, the deposit insurance scheme would be an unnecessary burden and that they would be subsidising the smaller banks by contributing the majority of the premium. It was also true that in the recent bank collapses, it was not the small depositors who brought a bank to its knees but the large depositors and the stoppage of interbank credit line. Nevertheless, with deposit insurance, Government regulators could afford more options in a bank crisis because they knew the small depositors were being taken care of. Mrs. Linda Tsao Yang, the California State's Saving and Loan Commissioner from early 1980 to the end of 1982, also agreed that in the presence of a deposit insurance system, the supervisory authority could afford to have more options in the situation where a bank faces an insolvency problem. She said:"The whole rationale of deposit insurance is to protect the small depositors having no access or knowledge to form an informed judgement as to the health of a bank. By doing so, it helps stabilise the public confidence and avoid a crisis atmosphere.....Since the average depositors are being protected, the supervisor would have the option to close down a bank."[68] She however agreed that if the bank in difficulty was of such a significant size that its collapse would cause a chain reaction in the financial market, the Government still had to step in, just as in the case of Continental Illinois Bank of the USA.

Another version of depositors's protection was introduced by David K.P.Li who suggested that the clearing house of the Hong Kong Association of Banks should be run by the association itself, instead of the present arrangement whereby it is run by the Hong Kong Bank. By doing so, Mr. Li said, the earnings from the use of funds in the clearing system could be used to establish a fund that would be available to reimburse depositors in any future bank failures.[69]

6. The Need for a Central Bank

A final point concerning the inadequacy of the new legislation was the failure of the Government to recognise the need for a body performing the full functions normally associated with a central bank. The person who propounded this theory most enthusiastically was again Mr. David K.P.Li He said the privileges that the Hong Kong Bank enjoyed for performing certain central banking functions were unfair to other banks in the territory and that there was a conflict of interest when such functions were performed by a private, profit-making bank.[70] He therefore felt that the fragmentation of central banking functions among different public and private institutions could impair the capability of forestalling and coping with a banking crisis.[71]

All these points should be studied by those who are interested in the banking industry. They carry both merits and demerits. With the collective wisdom of so many people, professionals and academics, a full answer acceptable to all is yet to be found. Perhaps there will be none. If an answer cannot be found, the most important thing is to ensure that we have learnt something from the crisis.

CHAPTER IX

LESSONS TO LEARN FROM THE CRISIS

The revised Banking Ordinance was without doubt an improvement towards better and tighter control. But in reality people can get round even the tightest rules. Today the banking industry is a fast changing one with new banking services and operating techniques being introduced. While legislators and banking supervisors have done their best to design a most up-to-date banking law, they have to remember the following lessons from the recent local experience:

1. A dynamic attitude is always required

The U.K. experience demonstrated the inadequacy of prudential regulation and supervision of parts of the money market. In the secondary banking crisis it could be seen that some organisations which had been insignificant in the past were playing active and important roles in the money market. The Bank of England reported to the Research Panel of the Wilson Committee that the strictness of the control on banks provided the opportunity for the secondary banks which had been outside the scope of the control.[72] This kind of development and loopholes in any banking legislation whereby there were new financial institutions or techniques to spring up will continue to be there. It was already certain that some changes in the local banking practices were underway. Banks engaged in more non-bank businesses and therefore exposed themselves to new risks.

Mr. Bill Brown, former Area Manager , Asia, of Standard Chartered Bank gave the following warning to local bankers:

> "The banks are doing more and more non-banking business, and they are doing more and more capital market business which is off-balance-sheet business with contigent risk.
>
> "How one assesses those risks and has adequate capital to cope with what could happen in those markets I think is the big issue.
>
> "Banks keep coming out with a lot of these marvellous new products involving underwriting facilities. The issue is that there has not been a major failure in that type of paper.
>
> "But at some time there will be, and at that time, a lot of people will be realising the real risks that are involved." (73)

He suggested that those involved in securities trading should look at recent developments in the London market to get an idea about what could happen in Hong Kong. He said:

> "Only recently, the FRN (Floating-rate Note) market in London came to a complete halt. To say the least, it created something of a flurry in the dovecote." (74)

Supervising banking operations has thus become a very sophisticated task. Bank examiners should not only use the traditional analytical skills but also pay attention to other macro and even international issues.

2. A New Attitude towards Bank Supervision

There was evidence that some of the fraudulent activities done by institutions, both locally and in the UK, could have been checked by the authorities before the out-break of the crisis. As Moran put it:

> "The failures of supervision revealed by the secondary banking crisis did not, therefore, arise chiefly from the confused state of the law, nor were they mainly due to failures of co-ordination. They arose from the excessive trust place by the authorities in the independent capacity of bankers to do business prudently." (75)

Commenting on the same issue, Clark also said:

> "The Bank (of England) had ample powers under existing (1948 & 1967) legislation to intervene in so far as it thought necessary and desirable. The problem was that it thought it undesirable to question another banker's word and, this being so, was prevented from evaluating whether it was necessary to do so........ However, what was less obvious was that the views of supervisors needed to become much more critical, to the point of hostility if need be." (76)

On the local front, the problem was similar in the sense that the Government had not supervised adequately a certain segment of the banking sector. Prof. Y.C. Jao pointed out in a recent article that because of the territory's being a financial centre for overseas Chinese, much more attention should be given to the changing business organisations, practices and leadership of the Chinese Diaspora all over the world.[77] He also said that the traditional family-owned businesses in Hong Kong urgently require modernization and reform.

3. One-sided Growth of the Economy

A common feature of the crises under review in Hong Kong and the U.K. was the lack of investment by the industrial sector compared with the marked attraction of property development as a hedge against inflation and as a vehicle for large capital gains. It was widely believed, prior to the crises, that property values could only go up. Statistic revealed that banks in Hong Kong lent too much of their assets to the property sector. In response to the plea of industrialists to set up an industrial bank, local Government officials always replied that banks in general were most willing to lend to all kinds of borrowers and that industrialists should find no problem to raise funds in the money market. This may be true in depressions when nobody wants to borrow. However, in times of heated economic activities, the market interest rate may only be acceptable to land developers who usually find it no problem to gain abnormal profits and to absorb any level of interest rate. Manufacturers who are selling in the competitive overseas market would therefore find that the market interest rate was beyond their affordable level. Experience demonstrated that, at times of high economic growth and heated economic activities, banks were lending a higher portion of their assets to property-related industries. The writer is of the opinion that the establishment of an industrial bank would not only help stabilize the economy but also the banking sector.

4. Endogenous Instability of the Banking Sector

Those who have a little knowledge of banking practices are well aware that the era of "asset management" has gone. Banks in virtually all parts of the world are practicing "liability management" techniques by buying from the wholesale money market the amount of funds required to meet the needs of their customers. This led Professor Hyman Minsky to formulate his theory of financial instability. He prostulated that the greater the need of units to manage their liabilities, the greater the susceptibility of the system to financial failures.[78] He therefore concluded that "it is the lender of last resort's (Hong Kong Government's?) responsibility to prevent the position-making difficulties of some institutions to lead to a generalised fall in asset values and to facilitate a recovery from a recession by aiding and abetting the restructuring of debts so that the element of speculative and Ponzi finance in the system is decreased." Following this theory, the case for a central bank in Hong Kong is stronger. The fragmented structure of central bank functions in Hong Kong is obviously unable to do this. There have been two banking crises in Hong Kong in the past two decades; one in 1964-65 and the other in 1982-86. In between there have been wild stock market speculation and gyrations one after another, suppressed bank runs and DTC failures, wild fluctuations in the property market and the breath-taking currency crisis of 1983. As a world financial centre, Hong Kong was also affected by world economic phenomena like the oil crisis, the slump of the shipping industry or even price changes in the world commodity markets. A sound banking system under the protection and guidance of a central bank might ensure a smooth run-up to 1997.

5. Choice of Economic Growth versus Financial Stability

Given the fact that fractional banking systems are suspectible to bank failures, one may ask whether traditional bank operations should be overhauled to minimize or eliminate the risk. It will be generally accepted that measures should be taken to fend off large-scale bank collapses in the future but not to the extent of hampering economic growth. Professor Y.C. Jao expressed the opinion that a "much more meaningful and complete criterion for evaluating the performance of a financial system is not whether it is immune from crisis or panic of any kind, but whether it can, in the long-run, mobilize and allocate the savings of the community to sustain a vigorous growth of the economy."[79] Sir Michael Sandberg, addressing the Hong Kong Society of Accountants in 1983, also said that the risk of aborting growth was just as serious as that of making bad loans.[80] He said:

> "But what would have happened in Hong Kong had banks refused to become involved in the risk of encouraging new textile industries, new electronic industries, the development of enterprises such as the Cross Harbour Tunnel.
>
> "We have not become the world's third largest financial centre in our own right by a policy of diffidence.
>
> "While we strive to apply sound banking and accounting principles and to bring more subtlety and sensitivity to the decision-making process, we must not lose sight of the splendid economic promise of our region....and of our pivotal role in its continued growth."

No one will argue with Sandberg. But the lesson to be learned by the authorities after the two crises in Hong Kong and the U.K. was that "high earnings might be an indicator of potential trouble from imprudent lending and that capital resources should be enough to cover the infrastructure of a bank plus some provision against loss on business risks, so that depositors' money should not be tied up for these purposes."[81] When a bank's profits look too good, special supervisory attention should be given.

6. International View to Bank Supervision

Peculiar to the local crisis only was the fact that most of the rescued banks have significant debts incurred outside of Hong Kong. The lesson from this was that Hong Kong, as an open economy, should be seen as an integrated part of the Southeast Asian financial system and must be expected to import some of its problems. In the early 1980's the slump in world commodity and oil prices that hit the Southeast Asian economy has badly affected the property and stock markets in Singapore and Malaysia. Banks which have significant exposure have thus imported some of the problems from outside. The collapse of Ka Wah was particularly obvious. The trouble of Pan-Electric Industries in Singapore in November 1983 with outstanding debts of S$400 million was a disaster to the bank. It was estimated that Tan Koon Swan, Pan-Electric's head, was the source of substantial guarantees underwriting Ka Wah's extensive Singapore and Malaysian portfolios.[82] The possibility of further crises to individual banks due to foreign economic slumps cannot be ruled out. While the memory of the collapse of the property market was still fresh, the all-too-similar collapse in the bulk tanker market has also caused some banks to experience liquidity difficulties. While banks still bear their own risks in the micro sense, the supervisory body should ensure that such large scale misfortune would not be transmitted to more sectors of the economy. While it is not recommended to hinder the internationalisation or diversification of banks' portfolios, the Banking Commissioner and his audit staff should pay attention to foreign economic influences.

Hong Kong has survived, though with pains, two large scale banking crises in the past two decades. It is hoped that the memory of them will always be kept by those concerned to prevent history from repeating itself for the third time in the future.

Appendix I

List of Court Cases Demonstrating Fraudulent Practices of Bank Managers and Directors During Hong Kong Banking Crisis, 1982-86

Name of bank	Details of Court Cases	Source of Information
1. Hang Lung Bank	A. Conspiracy of John Mao Kai-yan with several businessmen including directors and manager of Hang Lung Bank by operating a "cheque-kiting scheme" involving a total sum of US$21.7 billion between 1977 and 1982 which ultimately led to the collapse of Hand Lung Bank. Mao was sentenced to three years' jail.	"Big Cheque Kiting Scheme Revealed", SCMP, Oct.12,85
	B. In a related case, Eddy Ko Kin-wah, director and general manager of Dollar Credit and Financing Ltd., was convicted of charges of conspiring to defraud and false accounting. Ko was sentenced to six years imprisonment.	"Dollar Credit Boss convicted of fraud", SCMP, March 7, 1986
	C. Lee Hoi-kwong, director and Wai Yu-tsang, senior manager of Hang Lung were convicted of charges of conspiring to defraud of US$124 million belonging to the bank.	Wah Kiu Yat Po, Aug.5,1986
2. Overseas Trust Bank	A. Patrick Chang Chen-tsong, director of OTB admitted conspiring to defraud OTB of millions of dollars. He was sentenced to three years' jail on July 14,1986	"Chang admits massive OTB fraud", SCMP, July 12, 1986 and July 14, 1986
	B. T.C.Huang, former chairman of OTB and Simon Yip, chairman of the defunct Dominican Finance were arrested in USA by FBI in connection with the OTB failure. Yip was charged of 54 counts of conspiracy and false accounting and was to appear in court again in Feb.1987 for extradiction back to H.K.	Sing Tao Wan Pao, May 3,1986 & Dec.12,1986

Appendix I (continued)

	C. Dominic Cheung Kai-man, former manager of OTB's Macau branch pleaded guilty in a charge of conspiracy which exposed the bank to a risk loss of more than HK$140 million. He was sentenced to two years' imprisonment.	"OTB official admits conspiracy", SCMP, Dec.16,1986
	D. Chung Chiu-fat, former director of OTB was charged on 4 counts with Patrick Chang and Simon Yip in court on May 8, 1986	"Former DTC boss Yip is remanded", SCMP, May 9,1986
3. Wing On Bank	A. Lawrence Chu Cho-ham, president of the Chinese Manufacturers Association, was charged in c court on January 2, 1987 on conspiracy with the late Albert Kwok Chi-hong, former director and chief manager of the bank on 13 counts involving HK$60 million.	"Business leader in alleged $60m loan conspiracy", SCMP, Jan.3,1987
	B. "Five members of the Kwok family, including the chairman of Wing On Bank, are to give statements under caution to the Commercial Crime Bureau in the next few days, explaining their roles in variuous transactions involving the Wing On Bank........The Attorney-General will consider their statements next week and is expected to decide by next Friday whether any prosecution should be launched"	"Kwok to explain bank role", SCMP, March 5, 1987
4. Union Bank	A Former chairman Oen Yin Choy was arrested in San Francisco and subsequently charged on six counts of alleged false accounting and one count of alleged false statements involving about HK$218 million.	"Bank's fraud losses total $658m", SCMP, March 12,1987
	B."The Commercial Crime Bureau is considering charges against a number of people in connection with alleged false accounting at Union Bank of Hong Kong between 1979 and 1981."	"Other charges may follow Oen's arrest", SCMP, March 11,1987

APPENDIX II

Main Sources of Loss/Bad Debt

Name of Bank	Main Sources of Loss/Bad Debt	Source of Information
1. Hang Lung Bank	Loans of $544 million to Worldwide Properties which owns 27.5% of the bank's parent company	SCMP, Sep., 29, 1983
2. Overseas Trust Bank	A. Conspiracy by Patrick Chang etc. of $200 M	
	B. Cheque-kiting by Simon Yip which cost the bank US$67million.	SCMP, July 12, 1986
	C. OTB sued Singaporean business Datuk Tan Kim Chuo, formerly chairman of the bank, for repayment of a HK$122 million loan	SCMP, Dec., 28, 1986
3. Hong Kong Industrial and Commercial Bank	Loans of an unspecified amount were lent to borrowers who are believed to be associated with some former shareholders and directors of OTB with OTB shares pledged as security.	SCMP, Sept., 17, 1985
4. Ka Wah Bank	Loaned HK$1.5 billion in Singapore and Malaysia including HK$350 million to companies associated with Malaysian tycoon and politician Tan Koon Swan	SCMP, Oct. 23, 1986
5. Wing On Bank	Almost HK$275 million of bad and doubtful debts can be tied to the late Albert Kwok, chairman/	SCMP, Jan. 4, 1987
6. Union Bank	Fictitious loan made between 1975-84 may cost the bank HK$658 million, of which HK$218 million were alleged to be connected with Oen Yin Choy.	SCMP, March 12, 1987
7. Hong Nin Bank	Loans of HK$160 million to companies and individuals linked with the Fung Ping-fun group.	SCMP, Dec. 16, 1986

APPENDIX III

Southeast Asian Links of the banks in Trouble

Name of Bank	Southeast Asian Link	Source of Information
1. Hang Lung Bank	Malaysian businessman Chang Ming Thien has been a major shareholder for some time. After Chang's death in early 1982, his family members sold the stake. When the bank collapsed in Sept.1983, Philippino ethnic Chinese Chen Eng-kuan was the Managing Director. Chairman was Datuk Tan Kim Chua who was later sued by OTB for a HK$122 million loan.	"Ripples through the Maze", Far Eastern Economic Review, Oct.13, 1983 and SCMP, Dec.28,1986
2. Overseas Trust Bank	Chang Ming-thien was the chairman until his death in 1982.His son Patrick Chang was the managing director when the crisis surfaced.	"Chang admits massive OTB fraud", SCMP, July 12, 1986
3. Hong Kong Ind. and Commercial Bank	60 per cent owned by OTB	
4. Ka Wah Bank	Owned by the Malaysia-based Low family since 1975 until CITIC took over.	"The Banker", February 1986, pg 8
5. Wing On Bank	Local	
6. Union Bank	Founded by Chinese businessmen from Indonesia in 1964.Indonesian Chinese Oen Yin-choy was the chairman when the problems occurred.	"The Banker", February 1986, pg 8
7. Hong Nin Bank	Local	

NOTES

1. Robert Cottrell estimated that the cost of supporting the troubled banks probably runs to at least HK$3 billion, see Robert Cottrell, "Catalogue of errors with a public interest", Far Eastern Economic Review, May 8, 1986, p.60. The New China News Agency commented on October 25, 1986 (quoted by Hong Kong Daily News, October 26, 1986) that the Government committed HK$4 billion of the Exchange Fund in the rescue actions.

2. Leo Goodstadt, "Hong Kong Government to the Rescue", Asiabanking, April 1986, p.127.

3. South China Morning Post, February 12, 1983.

4. "Hang Lung takeover backed", South China Morning Post, September 28, 1983.

5. This can be found on all major newspapers in Hong Kong on September 28, 1983.

6. Anthony Rowley and Philip Bowring, "A timely takeover", Far Eastern Economic Review, October 13, 1983.

7. "Bremridge orders OTB to close doors", South China Morning Post, June 7, 1985.

8. Official announcement by the Hong Kong Industrial and Commercial Bank on South China Morning Post on September 13, 1985.

9. "Ka Wah secures standby credit line", South China Morning Post, June 8, 1985.

10. "Hong Kong banks: painful", Notes on world banking scene, The Banker, July 1986, p.6.

11. "Reasons sought for bank rescues", South China Morning Post, September 9, 1986 . Also on Hong Kong Daily News, May 25, 1986.

12. "Robert Cottrell, "Catalogue of errors with a public interest", Far Eastern Economic Review, May 8, 1986, p.60.

13. "Government rescues another bank", South China Morning Post, September 9, 1986.

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15. "The Secondary Banking Crisis and the Bank of England's Support Operations", Bank of England Quarterly Bulletin, Vol. 18, No.2, 1978.

16. Margaret Reid, The Secondary Banking Crisis, 1973-75, Macmillan, 1982, pp.16-17.

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18. "Bankers find holes in Fell's new strategy", South China Morning Post, February 24, 1986.

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22. Leo Goodstadt, "Property slump shakes bankers", Euromoney, January 1983, quoted by South China Morning Post, January 20, 1983.

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24. Ibid.

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27. Michael Clarke, op. cit., p.29.

28. Derek F. Channon, op. cit., pp.96-97

29. Robert Cottrell, "Catalogue of errors with a public interest", Far Eastern Economic Review, May 8, 1986.

30. "Fell sees bank mergers trend", South China Morning Post, September 5, 1986.

31. Leo Goodstadt, "Two more losses for Hong Kong", Asiabanking,January 1986, p.56.

32. Margaret Reid, op. cit., pp.100-101.

33. Ibid., p.114.

34. Derek F. Channon, op. cit.,pp.104-105, and Margaret Reid, "The Secondary Banking Crisis, five years on", The Banker, December 1978, p.30.

35. Margaret Reid, Ibid., p.30.

36. Margaret Reid, op. cit.,p.189.

37. "Fell sees bank mergers trend", South China Morning Post, September 5, 1986.

38. Hong Kong Daily News, September 28, 1983.

39. "Bremridge orders OTB to close doors", South China Morning Post, June 7, 1985.

40. Margaret Reid, op. cit.p.192.

41. "The business of financial supervision", lecture given by the Deputy Governor of the Bank of England on November 9, 1983 at the City of London Polytechnic. Reprinted on Bank of England Quarterly Bulletin, March 1984, p.49.

42. Margaret Reid, op. cit.,p.116.

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45. Refer to Note No.1.

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82. Leo Goodstadt, " Two more losses for Hong Kong", _Asiabanking_, January 1986, p.56.

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